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ECONOMIC IMPACTS OF AUSTRALIAN WOOL RESERVE PRICE FLOOR

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ABSTRACT:

It wasn't so long ago that the wool industry was one of Australia's main export earners. We once proudly proclaimed that 'Australia rode on the sheep's back' and our magnificent wool market brought Australia a great prestige. However, in the late 80s and early 90s, wool industry saw a major collapse. It is mainly attributed to the scuttling of the Reserve Pricing Scheme. Woolgrowers went bankrupt and textile firms faced huge financial losses resulting in tarnishing of our reputation internationally and creating enduring resentment and hastening the switch to synthetic fibres. With excess wool lying around the market, sheep had to be killed to stop further production. This article is a literature review paper analysing the impacts of Australian wool reserve price floor in relation to these events.

INTRODUCTION:

For 150 years from late 1840s, wool was the number one industry in Australia that helped build Australia by fulfilling a quarter of world's need for wool (Lee, 2011). The reasons behind Australia's high quality wool can be attributed to many factors, but are predominantly the experience and expertise of Australian farmers in selecting superior animals for breeding purposes, and in using the harsh Australian climate to produce clean, fine wool of high strength (Australian Bureau of Statistics, 2003). This massively successful Australian industry, however, suffered one of the greatest economic collapses. It was not only an economic collapse, its shocks were seen in Australia and beyond in terms of social upsets, murders, suicides, bankruptcy and many other untold social disasters. What were the reasons that resulted in this collapse? This is what we will explore through this article.

The Australian Wool Corporation (AWC) and the Wool Council of Australia were given the power by the government in the mid-1980s to set the floor price. This floor was used to drive up prices to artificial and unsustainable levels, which eventually bought about the demise of the scheme. The crash could only be described as Australian agriculture's greatest financial disaster. In January I99I the Australian Government announced the suspension (and later the abandonment) of the Wool Reserve Price Scheme. The price of wool fell overnight from 700 cents per kilo (c/kg) to 430 c/kg (Bardsley, 1994) leaving the Australian industry with a stockpile of 4-6 million bales of wool (close to one year's normal production) and a debt of A$2 7 billion with the famous Australian sheeps being shot around. The farmers and property investors sunk in debts as they were counting on the floor price to continue into the 1990s (Lee, 2011).

RESEARCH QUESTIONS:

1. The wool market had a price floor from the mid-1980s to the late 1990s. What does this mean and why did the Australian government impose this?

2. Is there a downside to having a price floor in any market in general and in the wool market in particular?
3. Instead of imposing a price floor in the wool market, what one other option could the Australian government have chosen?

PRICE FLOOR AND REASONS WHY AUSTRALIAN GOVERNMENT IMPLEMENTED THIS:

In order to effectively explain the implications of price floor between mid-1980s and late 1990s, a brief overview of price floor concept is presented first.

‘A price floor is the lowest legal price a commodity can be sold at. Price floors are used by the government to prevent prices from being too low. The most common price floor is the minimum wage--the minimum price that can be paid for labour. Price floors are also used often in agriculture to try to protect farmers.’(Taylor, 2006)

As described in the above mentioned definition, price floor means a government fixed price for commodities or services. During the mid-1980s and late 1990s, government introduced this fixed lowest price limits or the ‘price floor’ for the sale of wool.

Why did the Australian government impose this:

The reason why Australian government imposed this price floor is explained by Wool Producers, Australia who have described the wool reserve market scenario in the late 60's and early 70's when the wool prices were tumbling and there was concern that the overseas buyers were colluding to keep the price low. At that time, Australia had a record 180 million sheep. Considering these factors, Sir William Gunn convinced the Government of the day to introduce the reserve price scheme (“A wool man who changed the landscape,” 2003), a Government guarantee supporting a floor price for wool. A reserve price was accordingly introduced in 1974 with the intention to guarantee Australian wool growers a minimum price for their wool. The aim of the scheme was to stabilise future large movements in wool prices by purchasing wool which did not achieve the agreed floor price and then selling wool later in times of buoyant demand (Australian Bureau of Statistics, 2003). AWC and the Wool Council of Australia were given the power by the Labour Government in the mid-1980s to set the floor price.

Supply and Demand Diagram:

Before discussing the supply and demand diagram of this particular case study, following is a broad overview of basic economic principles of supply, demand and price relationship.

‘Supply and demand’ is an economic model of price determination in a market. It concludes that in a *competitive market*, the unit price for a particular good will vary until it settles at a point where the quantity demanded by consumers (at current price) will equal the quantity supplied by producers (at current price), resulting in an *economic equilibrium* of price and quantity (Besanko, Ronald R. Braeutigam, & Gibbs, 2011).

The four basic laws of supply and demand are:

- If demand increases and supply remains unchanged, then it leads to higher equilibrium price and higher quantity (as the demand needs to be fulfilled, purchase shall be made at a higher price)
- If demand decreases and supply remains unchanged, then it leads to lower equilibrium price and lower quantity (as the goods which are in abundance and not in demand can lead to huge capital tied in inventories or piles of waste)
- If supply increases and demand remains unchanged, then it leads to lower equilibrium price and higher quantity (excess goods have to be sold and it is not possible to do that with existing market demand and price which leads to reduction in price to encourage higher purchase quantities and achieving the equilibrium back)
- If supply decreases and demand remains unchanged, then it leads to higher equilibrium price and lower quantity (as buyers would be facing severe competition to fulfil their demands and keep themselves in business)

This was the scenario during the wool reserves price-floor times. Following demand and supply diagram depicts the scenario:

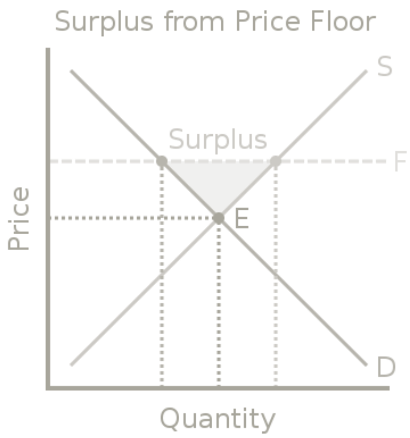

Figure 1: Surplus from wool price-floor

Where,

F = Price Floor, set for wool reserve by Government
D = Wool Reserves Demand
S = Wool Reserves Supplies
E = Equilibrium Price

It is evident that the price floor was set above the equilibrium price to ensure that wool growers get good return on wool production.

THE DOWNSIDE TO HAVING A PRICE FLOOR IN ANY MARKET:

The price floor can be set above or below the equilibrium price with certain side effects(Besanko et al., 2011).

A price floor can be set below the free-market equilibrium price. In this case, the floor has no practical effect. The government has mandated a minimum price, but the market already bears a higher price.

In contrary to that and exactly what Australian Wool Corporation did was to set the price floor above the free-market (equilibrium) price, to ensures that the prices stay high so that product can continue to be made. This approach has some downsides as well.

Consumers find they must now pay a higher price for the same product.

As a result, they

- *Reduce their purchases* or
- *Drop out of the market entirely*

In other words, the demanders will purchase the quantity where the quantity demanded is equal to the price floor, or where the demand curve intersects the price floor line.

Suppliers find they are guaranteed a new, higher price than they were charging before. As a result, they

- *Increase production*

In other words, the suppliers (producers) are willing to supply more than the equilibrium quantity and will supply where their marginal cost is equal to the price floor, or where the supply curve intersects the price floor line.

This causes an **economic imbalance** where the supply is in access ('Surplus') and demand is scarce.

If the surplus is allowed to be in the market then the price would actually drop below the equilibrium.

How to avoid price drops:

In order to prevent this, the government must step in with the following few options:

1. They can buy up the entire surplus (which was done by Australian Wool Corporation)

2. They can strictly enforce the price floor and let the surplus go to waste. This means that the suppliers that are able to sell their goods are better off while those who can't sell theirs (because of lack of demand) will be worse off. Minimum wage laws, for example, mean that some workers who are willing to work at a lower wage don't get to work at all. Such workers make up a portion of the unemployed (this is called "structural unemployment").

3. The government can control how much is produced. To prevent too many suppliers from producing, the government can give out production rights or pay people not to produce. Giving out production rights will lead to lobbying for the lucrative rights or even bribery. If the government pays people not to produce, then suddenly more producers will show up and ask to be paid.

4. They can also subsidize consumption. To get demanders to purchase more of the surplus, the government can pay part of the costs. This would obviously get expensive really fast.

Downsides of price floor for the wools reserves:

The three principle selling methods for wool include public auction, public tender and private treaty. However, over the recent years, 80-90% of the sales are through public auction. Reserve price scheme (price floor) was a key feature for this type of selling. Wool has an unstable and unpredictable demand patterns. Researchers have found higher price fluctuation in wool as compared to other commodities and difficulties in its demand forecasting. This implied sub-optimal decision responses (Oczkowski, 1997).

Discussing the wool reserves price floor scenario, Charles Massy, author of a detailed book on Australian wool industry's ups and downs, claims that this floor was used to drive up prices to artificial and unsustainable levels, which eventually bought about the demise of the scheme (Clancy, 2011).

Some of downsides of this price floor mentioned by Mr. Massy include:

- An over-supplied wool market and shooting of sheep
- A stockpile of 4.7 million bales
- An industry debt of $2.7 billion
- An overall industry cost as much as $12 billion

The scheme worked well, though, until the mid-eighties.

Richard House while discussing the honest intentions at the time of RPS implementation and explaining the impacts of price floor believes "At a time when rural commodities were struggling, the move to put a floor in the market at the cost of production to protect growers was probably well intentioned" (House, 2011). He continues, "But it appears for whatever reason, maybe *greed* or *arrogance*, the parameters were changed and it began to be used as *a measure to force prices up rather than guarantee a floor price*. "We are in a fibre market competing against other fibres and if we don't remain viable we don't survive. "Wool is like any other commodity where supply and demand will dictate price."

INSTEAD OF IMPOSING A PRICE FLOOR IN THE WOOL MARKET, WHAT ONE OTHER OPTION COULD THE AUSTRALIAN GOVERNMENT HAVE CHOSEN:

Following outlines a possible alternate strategy for Australian Wool Industry in mid-1980s:

- A thorough analysis of existing and future market fluctuations in demand based on local and international political, financial and economic situations
- A comprehensive study of existing wool industry supply patterns, factors affecting production and quality and supply stability
- Comparison between:
    - maximum demand and minimum production,
    - maximum demand and maximum production,
    - minimum demand and minimum production,
    - minimum demand and maximum production

- Identification of possible surplus or deficits/ shortages from above analysis
- In case of higher expected shortages, development of future markets and incentives for local growers including subsidies, training and development, increased competitive advantage attainment against the alternate exporting countries
- In case of higher surplus expectation, encouraging production of other commodities and effectively utilizing resources to add productivity, utilization of quota system with tailor-made design, taxes and other arrangements
- Another arrangement where surplus is expected and other industries cannot be immediately developed, governments can offer certain financial assistance (weighed with the expected loss of overproduction and stock-keeping costs) to the disadvantaged industry

If support is required for certain disadvantages industries, it is always useful to shift their demand curve upward which results in an increased demand at the same price. Equilibrium price also moves up and greater revenue is available.

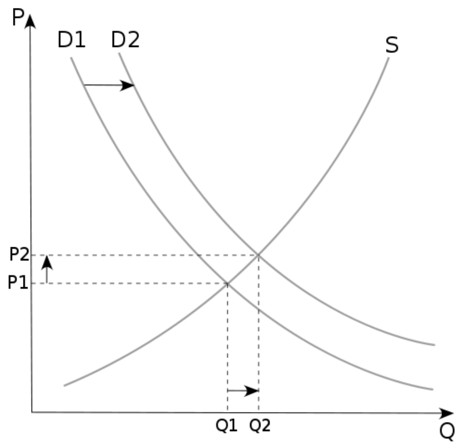

Figure 2: Demand curve shift

This was one of the recommendations of 'The Committee for Retention and Improvement of Free Wool Market' (1965): "The positive strategy for wool growers is to make wool available in sufficient quantities to keep the price competitive with substitutes. If funds are available from grower or government sources, it would be a real contribution to future of wool growing to apply them to a dynamic policy aimed at increasing the demand for wool. This could be done through vigorous programs of research and promotion which would improve the product and presentation". (The Committee for Retention and Improvement for the Free Wool Market, 1965)

CONCLUSION:

The current situation of Australian wool industry where it is producing a third of what it used to produce a decade ago (Fitzgerald, 2011). Massy in his comprehensive case study 'Breaking The Sheep's Back' concludes that the collapse of the reserve price scheme not only constitutes, by a wide margin, Australia's largest business-corporate collapse but that the scheme was "one of the worst government-generated policy calamities in Australian history" (Massy, 2011). From the analysis presented in this article, we have seen the economic aspects related to downfall, potential mistakes

in approach adopted to deal with this issue and matters that could have been handled differently. It is important that we learn from our past by thoroughly analysing it and construct our future by thoroughly planning it. Australia's future is bright and it is in our hands to make it even brighter.

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